DOW, LOHNES & ALBERTSON
ATTORNEYS AT LAW
1255 TWENTY-THIRD STREET
WASHINGTON, D. C. 20037-1194

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EX PARTE OR LATE FILED

LAURA H. PHILLIPS
DIRECT DIAL NO.
857-2824

TELEPHONE (202) 857-2500
FACSIMILE (202) 857-2900

June 28, 1995

VIA MESSENGER

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

Mr. William F. Caton
Secretary
Federal Communications Commission
1919 M Street
Washington, D.C. 20554

EX PARTE

Re: CC Docket No. 87-266
CC Docket No. 94-1

Dear Mr. Caton:

Enclosed please find two copies of a letter from James O. Robbins, President and CEO, Cox Communications, Inc., to Honorable Reed E. Hundt, Chairman of the Federal Communications Commission delivered today to Chairman Hundt, Commissioner Quello, Commission Barrett, Commissioner Ness and Commissioner Chong. Please add this letter to the record in the above-referenced dockets.

Please contact the undersigned should you have any questions with regard to this filing.

Sincerely,

Laura H. Phillips

cc: Chairman Hundt
Commissioner Quello
Commissioner Barrett
Commissioner Ness
Commissioner Chong

James O. Robbins
President and Chief Executive Officer

Cox Communications, Inc.
1400 Lake Hearn Drive NE
Atlanta, Georgia 30319
[redacted]

COX COMMUNICATIONS

June 28, 1995

The Honorable Reed E. Hundt
Chairman
Federal Communications Commission
1919 M Street, NW, Room 814
Washington, D. C. 20554

Dear Mr. Chairman:

Much is made about an assertion that price cap regulation of LECs eliminates their incentive to cross subsidize new services from their monopoly rate base. Flowing from this assertion, it is argued that there is no need for the FCC to impose reasonable cost allocations between telephony and video dialtone services because price caps eliminate cross-subsidies.

Enclosed is a white paper by Snavely King and Associates which debunks this assertion whether it is based on: (1) the FCC's existing price cap regime; or (2) a theoretically reformed FCC "pure" price cap regime in which sharing options are eliminated.

First, the FCC's existing price cap regime permits LECs to game the system by moving from high price caps with no sharing to lower price caps with sharing as their anticipated revenues and future sharing obligations dictate. If LECs misallocate costs to telephony, thereby artificially depressing telephony earnings, virtually all of the productivity benefit from the price cap is lost. In other words, under the existing Commission's price cap regime, the LECs have every incentive to transfer virtually all of the costs of VDT to their captive rate base.

Second, even if the Commission reforms its existing price cap regime to eliminate the sharing options, some adverse effects of cross-subsidy from improper cost allocation will remain because the misallocation of common costs to telephony always will deflate the productivity factor and offset the expected decline in regulated telephone costs to consumers.

Third, under existing jurisdictional separations rules, state regulators face 75% of the consequences of cost misallocation to telephony without any remedy under the VDT tariff process. Moreover, many state regulators face changes in state law which, under reform of state price caps, forbid the collection of cost and revenue data needed to address the local VDT cross-subsidy issues.

Cost accounting without cost allocation is like Yin without Yang. The responsibility to confront and decide this fundamental public policy issue quite simply cannot be avoided by claiming price caps prevent cross-subsidy since, as our analysis shows, they do not. In light of this reality, the Commission should immediately take several concrete steps to protect telephone ratepayers: (1) revise Part 64 and 36 accounting rules to separate all video dialtone costs from telephone costs prior to the jurisdictional separation process; (2) determine a reasonable allocation of common costs that must be applied in all VDT tariffs; and (3) impose procedures that exclude VDT from price caps and from all price cap productivity factor calculations.

Sincerely,

Jim Robbins

Enclosure

cc: The Honorable James H. Quello
The Honorable Andrew C. Barrett
The Honorable Rachelle B. Chong
The Honorable Susan Ness

Effect of Video Dialtone Cross-Subsidies on Price Cap Carriers

Report by
Snavely, King & Associates, Inc.
to Cox Enterprises, Inc.

The video dialtone systems proposed by a number of Local Exchange Carriers ("LECs") are not profitable. In LEC filings, common video/telephony costs and corporate overhead costs are underassigned to video dial tone. As these video dialtone systems are built, they will be financed and sustained by heavy cross-subsidies from telephony operations.

The argument has been made that cross-subsidies are of no consequence to ratepayers of monopoly telephone services because the "price cap" scheme adopted by the Federal Communications Commission ("FCC") insulates consumers from the effects of misallocations. Telephone ratepayers, it is argued, are protected from any effects of overstated costs, including cross-subsidies of video dialtone services, because the LEC's actual costs and productivity are not used in the formula for updating the price cap. The formula simply subtracts the productivity option chosen by the LEC from the inflation rate (see Figure 1 attached for options).

The way this consumer insulation is supposed to work is illustrated by Figure 2. A carrier electing the "pure" price cap option (i.e. no requirement to share profits above a certain amount with ratepayers) must offset inflation by an annual productivity

factor of 5.3 percent, but it may keep any earnings it can achieve. Inflation is assumed to be 3.3 percent annually in this illustration. Therefore the price cap index declines 2.0 percent each year. This is the rate by which the hypothetical carrier must reduce its telephone rates.

The illustration continues by assuming that the carrier actually achieves a 5.3 percent productivity and thus earns 13.65 percent each year. However, the rate of return, whatever it is, has no bearing on the movement of the price cap index.

There are three reasons why the argument illustrated by Figure 2 is wrong, and why video dialtone cross-subsidies do affect telephone ratepayers. The three reasons relate to (1) jurisdictional separations, (2) interstate profitability, and (3) industry productivity.

1. Jurisdictional Separations

By law, the FCC must separate the costs of telephony between interstate and intrastate services. At present, there is no formal recognition of video dialtone services in the Part 36 separations rules. To date the allocation of costs for video dialtone are following the allocations contained in the LECs' proposed video dialtone tariffs. If these proposed tariffs understate the cost of video dialtone, they overstate the cost of telephone services. Existing separations procedures (Part 36) allocate approximately 75 percent of telephone service costs to

the intrastate jurisdiction. Thus, each $1.00 overstatement of telephone costs by reason of video dialtone cross-subsidies inflates intrastate jurisdictional costs by 75¢.

Whether or not a carrier chooses the no sharing "pure" price cap option for interstate services has absolutely no effect on intrastate ratemaking. The only way to protect intrastate telephone ratepayers from paying for video dialtone subsidies is to ensure that intrastate telephone costs do not include video dialtone costs. To address this issue, the Commission should revise its Part 64 accounting rules to separate all video dialtone costs from telephone costs before these costs are separated by jurisdiction. This will ensure that no video dialtone costs will be supported by intrastate telephone ratepayers.

2. Interstate Profitability

According to LEC tariff filings, the provision of video dialtone service in the initial years will increase costs more than revenues. This early unprofitability will influence the LECs' choice of price cap options. As discussed above, the "pure" price cap option requires a 5.3 percent productivity offset and results in an annual rate reduction of 2.0 percent. However, if the carrier anticipates that video dialtone will lower its overall profits, it will not opt for the "pure" price cap option, but will choose one of the "sharing" options that does not carry such a high productivity offset. The carrier will opt for the price cap option

which minimizes its total rate reduction requirement as a result of both the formula and sharing. The carrier will choose the lowest productivity offset available, unless this choice will cause it to lower rates more through sharing than it avoids by choosing a low productivity offset.

In Figure 3, it is assumed that the carrier initially earns 13.65 percent, which is above the 12.25 threshold for sharing under the two sharing options. However, consistent with the data from LEC tariffs, Figure 3 assumes that video dialtone costs reduce realized productivity by 3.0 percent to 2.3 percent. This drop in productivity will cause lower earnings. Anticipating this, the carrier will choose the 4.0 percent productivity factor, the lowest price cap productivity option. This choice produces a net annual price reduction of only 0.7 percent. Under this option, the carrier must share earnings between 12.25 and 13.25 percent on a 50/50 basis, and it must refund all earnings greater than 13.25 percent. In this illustration, video dialtone service has reduced the carrier's return to 12.80 percent. Therefore, sharing deprives the carrier of only .275 percent [1] of its earnings in the first year. In the second and third years, video dialtone further depresses earnings to 11.95 percent and 11.10 percent, respectively, so the carrier shares no earnings whatever.

Since carriers choose one of the three price cap options each

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[1] 12.80%-12.25% = .55% x 50% = .275%

year, the advent of video dialtone will likely result in a migration of LECs from the highest productivity, non-sharing option to the lower productivity, sharing options. As demonstrated by the first three years of Figure 3, the effect on ratepayers is an annual price cap adjustment that is 1.3 percentage points higher with video dialtone than without it.

The Commission can insulate interstate telephone ratepayers from this effect by imposing procedures to exclude video dialtone revenues and costs from the earnings that are used to compute the sharing obligation. However, if there is a cross-subsidy, and a portion for the common costs that should be assigned to video dialtone are assigned to telephone services, this exclusion fails to resolve the problem. Telephone service earnings will decline, and carriers will opt for the lower price caps in the confidence that they will not become subject to earnings sharing.

3. Industry Productivity

In its recent price cap order, the Commission found merit in basing the productivity offset in its price cap mechanism on a moving 5-year average of the industry's productivity performance. The effect of adding significant new video dialtone inputs without a corresponding (in the near term) increase in outputs will be to reduce the industry's productivity performance. The moving average of productivity performance will decline, and with it the productivity offset.

The consequence of this effect is illustrated in Figure 3 in Years 4, 5, and 6. Figure 3 assumes that in Year 4 the Commission observes that the industry's productivity performance has fallen to 2.3 percent and the productivity offset is set at this level. Combined with an inflation rate of 3.3 percent, this offset allows an annual increase in rates of 1.0 percent, instead of the 2.0 percent decrease discussed above.

Again, the Commission can insulate telephone ratepayers from this effect by imposing procedures to exclude video dialtone inputs and outputs from the annual productivity performance calculation. However, if there are cross-subsidies, and video dialtone costs are allowed to inflate telephony inputs, then the telephone productivity factor will decline in spite of the Commission's efforts to segregate these two lines of business for purposes of rate regulation.

Conclusion

In the attached illustration, the cumulative six-year effect of video dialtone on interstate telephone ratepayer is an increase of 12.9 percent in their rates. With no video dialtone costs, rates fall by 12.0 percent, as shown on Figure 2. With video dialtone costs, rates increase by 0.9 percent. This is in spite of the fact that the hypothetical LEC began, in Year 0, as a "pure" price cap carrier. Moreover, even if the FCC changes its existing price cap plan by eliminating the sharing options altogether, the

adverse effects of cross subsidy from improper cost allocation will persist. This is because the telephone productivity factor will be deflated as described above. Ultimately, without reasonable cost allocations, interstate and intrastate telephone ratepayers will bear the burden of supporting those cross-subsidies.

EFFECT OF VDT CROSS-SUBSIDIES ON PRICE CAP CARRIERS

Figure 1 - FCC Price Cap Options

PRODUCTIVITY FACTOR OPTION	EXCESS EARNINGS SHARED WITH RATEPAYERS
4.0%	50% of earnings between 12.25% and 13.25% 100% of earnings over 13.25%
4.7%	50% of earnings between 12.25% and 16.25% 100% of earnings over 16.25%
5.3%	No Sharing Required

EFFECT OF VDT CROSS-SUBSIDIES ON PRICE CAP CARRIERS

Figure 2-Base Case (5.3 percent productivity assumed)

YEAR	INFL	PROD	PRICE	ROR
0	-	-	-	13.65% *
1	3.3%	5.3%	(2.0%)	13.65%
2	3.3%	5.3%	(2.0%)	13.65%
3	3.3%	5.3%	(2.0%)	13.65%
4	3.3%	5.3%	(2.0%)	13.65%
5	3.3%	5.3%	(2.0%)	13.65%
6	3.3%	5.3%	(2.0%)	13.65%
TOTAL	-	-	(12.0%)	-

Figure 3-VDT Costs Added To Telephone (2.3 percent productivity assumed)

YEAR	INFL	PROD	PRICE	ROR
0	-	-	-	13.65%
1	3.3%	4.0%	(0.7%)	12.80%
2	3.3%	4.0%	(0.7%)	11.95%
3	3.3%	4.0%	(0.7%)	11.10%
4	3.3%	2.3% **	1.0%	11.10%
5	3.3%	2.3%	1.0%	11.10%
6	3.3%	2.3%	1.0%	11.10%
TOTAL	-	-	0.9%	-

* RBOC 1994 Actual (Authorized is 11.25 percent).
** Assumes productivity target lowered by 3.0 percentage points.
Note: This chart assumes FCC adopts rules to separate VDT from telephone costs for intrastate ratemaking.